Nos. 06-1457, 06-1462

IN THE

Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC., *et al.*,
Petitioners,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY WASHINGTON, *et al.*,
Respondents.

CALPINE ENERGY SERVICES, L.P., *et al.*,
Petitioners,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY WASHINGTON, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR RESPONDENT GOLDEN STATE WATER COMPANY

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QUESTION PRESENTED

The Federal Power Act declares that any "rate or charge" for the sale of electric energy within the jurisdiction of the Federal Energy Regulatory Commission that is "not just and reasonable" is "unlawful," 16 U.S.C. § 824d(a), and requires the Commission, whenever it finds, upon complaint, that "any rate, charge . . . or contract" for such a sale is "unjust [or] unreasonable," to "determine the just and reasonable rate, charge, . . . or contract" and "fix the same by order," *id.* § 824e(a). Did the Commission contravene the directive to determine just and reasonable rates by denying such a complaint because a contract's rate, even if unjust or unreasonable, was not contrary to the public interest?

CORPORATE DISCLOSURE STATEMENT

Respondent Golden State Water Company's parent company is American States Water Company. American States Water Company has no parent company, and no publicly held company owns more than 10% of its stock.

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BRIEF FOR RESPONDENT GOLDEN STATE WATER COMPANY

STATEMENT

These cases involve the response of the Federal Energy Regulatory Commission (FERC or the Commission) to the energy crisis in the western states in 2000-2001, "the worst electricity-market crisis in

American history." FERC Br. at 16. Over several months, FERC imposed increasingly stronger price controls on the spot market[1] for wholesale electricity to ensure "just and reasonable" rates as required by section 205(a) of the Federal Power Act (FPA), 16 U.S.C. § 824d(a). Simultaneously, it urged California utilities to reduce their demand in the wholesale spot market by signing long-term purchase contracts with power suppliers. The Commission did not impose price controls on these contracts, but to address concerns that these contract prices might be unjust and unreasonable during the next year, it stated that it would rely on purchasers to file complaints under section 206(a) of the FPA, 16 U.S.C. § 824e(a), and it adopted a just-and-reasonable benchmark price for evaluating such complaints.

Respondent Golden State Water Company, formerly named Southern California Water Company (SCWC), filed a complaint pursuant to this order.[2] The complaint requested that FERC "determine the just and reasonable rate," *id.*, for a long-term wholesale purchase contract SCWC had signed at the prevailing market price—which was 28% more than FERC's benchmark—before FERC stabilized the market by ordering its final spot-market price controls.

By a 2–1 vote, FERC denied the complaint. It held that market conditions, the benchmark price, and the statutory just-and-reasonable standard were irrelevant. In FERC's view, this Court's decisions in *United*

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[1] Under FERC's definition, spot-market sales are for 24 hours or less and are entered into the day of or the day before delivery. JA 674a n.3.

[2] This brief will use the company's former name to remain consistent with the record below.

Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), imposed a much higher standard, which prohibited it from modifying the contract rate unless it was contrary to the public interest. It concluded that no such showing had been made, because SCWC was financially able to continue utility service, SCWC's retail customers were not bearing an "excessive burden" despite a 38% overall rate increase, and SCWC had voluntarily signed the contract.

In the same orders, FERC denied similar complaints by Public Utility District No. 1 of Snohomish County, Washington (Snohomish), and Nevada Power Company and Sierra Pacific Power Company (together, the Nevada Companies).

The court of appeals granted petitions for review by SCWC, Snohomish, the Nevada Companies, and the Bureau of Consumer Protection of the Office of the Attorney General of the State of Nevada, and remanded the matter for reconsideration. It held that FERC's reliance on *Mobile* and *Sierra* to change the rate-review standard was improper and that FERC's findings were not in accord with the statute. Pet. App. 1a.[3]

The certiorari petitions do not seek review of the court of appeals' judgment insofar as it granted SCWC's petition for review. Neither FERC nor Mirant Energy Trading, LLC (the successor to Mirant Americas Energy Marketing, L.P., the selling party in SCWC's contract) filed a certiorari petition. Accord-

[3] All references to "Pet. App." are to the appendix to the petition in No. 06-1457.

ingly, the court of appeals' judgment is final as to SCWC's petition for review.[4]

Nonetheless, FERC's brief recites findings by the administrative law judge (ALJ) concerning SCWC's complaint and argues that FERC's findings underlying its denial of the complaint were supported by substantial evidence and reasonable. FERC Br. at 11-13, 43-44, 46. Mirant, as a respondent under Rule 12.6, joined the brief of petitioners Calpine Energy Services, L.P., *et al.* in No. 06-1462, which makes similar arguments. Calpine Br. at 19-21, 42-44. Because of the persistence with which FERC—in both its orders and its brief—and Mirant have tried to gloss over important facts concerning FERC's rulings, SCWC deems it necessary to outline the facts disclosed by the record in some detail. The facts of SCWC's case demonstrate the erroneous legal standards FERC employed in deciding these cases. They also show why the arguments by the petitioners, Mirant, their supporting *amici*, and FERC for reversal of the court of appeals' judgment should be rejected.

A. Statutory and Regulatory Background

1. In the Public Utility Act of 1935, 49 Stat. 803, Congress amended the FPA in order "to curb abusive

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[4] Judicial review of a FERC order under the FPA is governed by section 313(b) of the statute, 16 U.S.C. § 825*l*(b), which provides that "[t]he judgment and decree of the court [of appeals], affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28." The court of appeals entered judgment granting the four petitions for review and issued its mandate on February 13, 2007. JA 342a.

practices of public utility companies by bringing them under effective control, and to provide effective federal regulation of the expanding business of transmitting and selling electric power in interstate commerce." *Gulf States Utils. Co. v. FPC*, 411 U.S. 747, 758 (1973). The FPA gives the Commission[5] jurisdiction over the transmission and wholesale sale of electric energy in interstate commerce. 16 U.S.C. § 824(b)(1). Section 205(a) provides that "[a]ll rates and charges made, demanded, or received by any public utility" for the sale of electric energy subject to FERC jurisdiction "shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful." 16 U.S.C. § 824d(a). To enable FERC to enforce this mandate, section 205(c) requires a public utility to file schedules showing all such rates and charges, "together with all contracts which in any manner affect or relate to such rates [or] charges." *Id.* § 824d(c). A public utility may not change its rate schedules without filing the changed rate with FERC. *Id.* § 824d(d). Under section 205(e), FERC may suspend the changed rate for up to five months, after which it goes into effect subject to refund if FERC ultimately finds the increase is not justified. *Id.* § 824d(e).

Section 206(a) gives FERC the authority and obligation to modify rates and contracts for wholesale electricity sales upon a finding of their unlawfulness:

> Whenever the Commission, after a hearing held upon its own motion or upon complaint, shall

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[5] Originally this meant the Federal Power Commission (FPC). Section 402(a)(1) of the Department of Energy Organization Act of 1977, 42 U.S.C. § 7172(a)(1), transferred the functions at issue in this case to FERC.

> find that any rate, charge or classification . . . or that any rule, regulation, practice, or contract affected [sic] such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice or contract to be thereafter observed and in force, and shall fix the same by order.

Id. § 824e(a).

2. In *Mobile*, this Court construed the "substantially identical," *Sierra*, 350 U.S. at 353, provisions of sections 4 and 5 of the Natural Gas Act (NGA), 15 U.S.C. §§ 717c-717d. The Court held that the NGA, "by requiring contracts to be filed with the Commission, . . . expressly recognizes that rates to particular customers may be set by individual contracts," *Mobile*, 350 U.S. at 338, and that the statute's rate-filing procedure did not give a regulated natural gas pipeline company the power to increase a contract rate, without the customer's consent, by filing a new rate, *id.* at 343-44. But, the Court noted, "denying to natural gas companies the power unilaterally to change their contracts in no way impairs the regulatory powers of the Commission, for the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest." *Id.* at 344. "The Act thus affords a reasonable balance between the conflicting interests of contract stability on the one hand and public regulation on the other." *Id.*

Sierra concerned a federally regulated public utility that had unilaterally filed an increased rate in a wholesale power-supply contract with a distribution-utility customer. The issue was whether the FPA em-

powered the FPC to increase the contract rate based on a finding that the new rate was not unreasonably high. The Court noted that section 206(a) gave the FPC "undoubted power . . . to prescribe a change in contract rates whenever it determines such rates to be unlawful," and that the "condition precedent" to exercising that power "is a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory, or preferential.'" 350 U.S. at 353 (quoting section 206(a)). But the Court held that the FPC could not use its conclusion that the contract rate yielded the seller less than a fair return on its investment as the basis for a finding that the contract was "unreasonable" as required by section 206(a). *Id.* at 354-55. Because "the purpose of the power given the Commission by § 206(a) is the protection of the public interest, as distinguished from the private interests of the utilities," the Court concluded that "a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Id.* at 355. "In such circumstances," the Court noted, the "sole concern" under the statute "would seem to be whether the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Id.* at 355.

The *Mobile* and *Sierra* holdings, then, were fourfold: (1) regulated sellers can establish FERC-jurisdictional rates by contract as well as unilateral tariffs; (2) the statutory rate-filing procedure does not empower the seller to change its contracts unilaterally; (3) the power to change such contracts without the parties' mutual consent belongs to FERC alone; and (4) whenever FERC changes a rate—

whether in contract or not—it may do so only to protect the public interest as defined by the statute.

3. Although the FPA does not prescribe a particular method for establishing just and reasonable rates, FERC traditionally has reviewed rates based on the cost of providing service. *See* 18 C.F.R. §§ 35.12, 35.13 (2007). In recent years, however, FERC has waived the cost-of-service filing requirement and approved electricity sales at market-based rates. *See* Market-Based Rates for Wholesale Sales of Electric Energy, Capacity, and Ancillary Services by Public Utilities, Order No. 697, 72 Fed. Reg. 39,904 (July 20, 2007), *petition for reh'g pending*. The Commission grants a public utility blanket market-based rate authority upon a showing that it lacks, or has adequately mitigated, any market power. This blanket authority allows the public utility to make sales at changing market rates without the prior notice and filing of each contract and new rate; instead, FERC requires the public utility to file periodic reports on its market-based rate transactions after the fact. *Id. See California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1012, 1014 (9th Cir. 2004) (upholding lawfulness of market-based rate tariffs if "conditioned on the existence of a competitive market" and "coupled with enforceable post-approval reporting that would enable FERC to determine whether the rates were 'just and reasonable' and whether market forces were truly determining the price"); *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir 1998) ("[w]here there is a competitive market," FERC may rely on market-based rates to satisfy just-and-reasonable requirement).

B. Factual Background

1. The Western Energy Crisis and FERC's Initial Response

Under a 1996 state law, California restructured its electric-utility industry. The law required a Power Exchange (PX) to operate a wholesale spot market and an Independent System Operator (ISO) to operate the transmission grid and a wholesale spot market for energy used to maintain reliable service. The law required the state's three largest investor-owned utilities (IOUs)—Southern California Edison Company, Pacific Gas and Electric Company, and San Diego Gas and Electric Company—to transfer control of their transmission systems to the ISO and (with exceptions irrelevant here) to sell all electricity they generate, and purchase all electricity their retail customers require, in the PX and ISO spot markets. *See Pub. Utils. Comm'n of Cal. v. FERC*, 462 F.3d 1027, 1036-44 (9th Cir. 2006); *Lockyer*, 383 F.3d at 1008-11; *In re Cal. Power Exch. Corp.*, 245 F.3d 1110 (9th Cir. 2001).

In late May 2000, wholesale electricity prices in California increased to unprecedented levels. The PX day-ahead market price reached 15 times the pre-restructuring average cost. *See Cal. Power Exch.*, 245 F.3d at 1115 n.2. Moreover, "non-compliance with FERC's reporting requirements was rampant . . . while energy prices skyrocketed and rolling brown-outs threatened California's businesses and citizens." *Lockyer*, 383 F.3d at 1014. "Despite the promise of truly competitive market-based rates, the California energy market was subjected to artificial manipulation on a massive scale." *Id.*

On November 1, 2000, FERC concluded that the California market structure and rules were "seriously

flawed" and "provide the opportunity for sellers to exercise market power when supply is tight and can result in unjust and unreasonable rates." *San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121, at 61,349-50 (2000). "These higher spot market prices in turn affect the prices in forward markets." *Id.* at 61,367.[6]

On December 15, 2000, FERC ordered its initial remedies. JA 477a (December 2000 Order). It had "no assurance that rates will not be excessive relative to the benchmarks of producer costs or competitive market prices," and concluded that "unjust and unreasonable rates . . . could continue to be charged unless remedies are implemented." JA 535a-536a.

The Commission's "fundamental remedy" was to have California's IOUs sign long-term purchase contracts instead of purchasing in the spot markets. JA 515a-516a, 518a. It terminated the PX's wholesale tariffs to end the IOUs' reliance on the PX spot market, JA 538a, and "strongly urge[d] the IOUs to move their load to long-term contracts of two years or more." JA 519a.

The Commission recognized that its order would abruptly move a large portion of California's 40,000-megawatt (MW) demand into the long-term markets and could drive up long-term contract prices. JA 522a. Although declining to impose price controls on these contracts, JA 521a, 541a, FERC assured that it would "be vigilant in monitoring the possible exercise

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[6] The forward, or long-term bilateral, market is the informal, decentralized market in which energy is sold in advance using contracts for the future delivery of energy at an agreed-upon price (the "forward price"). *See* Steven Stoft, Power System Economics 90, 203, 446 (2002).

of market power," JA 520a, and would use complaint proceedings to remedy unlawful contract prices:

> To address concerns about potentially unjust and unreasonable rates in the long-term markets, we will monitor prices in those markets and also adopt a benchmark that we will use as a reference point in addressing any complaints regarding the pricing of long-term contracts negotiated over the next year, after which time the sudden increase in forward demand will have subsided.

JA 522a; *see also* JA 484a, 541a. The Commission set this benchmark price at $74 per MW-hour (MWh) for "five-year contracts for supply around-the-clock," based on the average generation costs in California's retail rates before restructuring and the higher natural-gas prices prevailing in late 2000. JA 522a-523a.

In addition, FERC adopted interim measures to review and possibly mitigate California spot-market prices until May 2001, when it expected to adopt a permanent market-monitoring plan. JA 530a-531a.

California's large IOUs and power suppliers did not sign long-term contracts as FERC had hoped. When the IOUs' creditworthiness deteriorated, California enacted emergency legislation effective February 1, 2001, under which the California Department of Water Resources (DWR) purchased power for them. DWR began negotiating long-term power contracts and within a few weeks executed numerous contracts with multiple suppliers. *See Pub. Utils. Comm'n of Cal. v. FERC*, 474 F.3d 587 (9th Cir. 2006), *petition for cert. filed* (Nos. 06-1454 and 06-1468).

2. Southern California Water Company's Energy Purchase Contract

SCWC owns and operates a retail electric utility distribution system, Bear Valley Electric Service, serving about 22,000 customers in the Big Bear Lake area of San Bernardino County, California. It provides electric service primarily to residential customers in a resort community with a mix of full-time and part-time residents, although it also serves about 1,500 commercial, industrial, and public-authority customers, including two ski resorts. Because SCWC owned no transmission lines and generated no electricity, the principal requirements of California's 1996 restructuring law did not apply to it.

To avoid buying electricity entirely from the PX spot market, SCWC executed a one-year contract with Dynegy Power Marketing, Inc. (Dynegy), commencing May 1, 2000, to purchase 12 MW of firm (uninterruptible) around-the-clock energy at a price of $35.50/MWh. ER 686-87.[7] This contract supplied SCWC's base load (*i.e.*, constant, year-round) energy requirements at a fixed price, and the vast majority of SCWC's annual energy requirements.[8]

After FERC issued its December 2000 Order, and DWR began purchasing energy for California's large IOUs, Dynegy informed SCWC that it was not interested in continuing its energy sale to SCWC after April 2001, if it could sell its generation output to DWR instead. ER 687. Dynegy ultimately informed

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[7] All references to "ER" herein are to the Excerpts of Record filed in the Ninth Circuit.

[8] In 2001, SCWC served an average load of 16.3 MW, with a summer peak of about 23 MW, and a winter peak of about 37 MW. ER 687-688.

SCWC that it would not extend their contract, as it had committed all its energy to DWR. ER 494.[9] Other marketers told SCWC that they were focusing on selling to DWR and were not interested in selling to SCWC. ER 160; ER 520.

On March 7, 2001, SCWC sent a request for proposals (RFP) for 15 MW of firm power to the six major power marketers operating in California (including Dynegy). On March 14, SCWC received responses from Enron Power Marketing, Duke Energy Trading and Marketing, and Mirant. ER 159, 692, 710. The proposals ranged from $194.50 for a one-year contract to $84 for a seven-year contract. ER 496. SCWC eliminated Duke's response as too expensive and determined that a five-year contract was the lowest cost relative to expected prices. ER 692, 710, 725.

Mirant's March 14 response had quoted a nonbinding, "indicative" price of $89 for a five-year contract. ER 469. But on March 15, Mirant stated that its firm offer was now $94. ER 471. Enron's offer was higher. ER 692. On March 16, Mirant raised its offer to $95, which SCWC decided to accept. ER 692-93, 699.

They memorialized their contract using the Western Systems Power Pool (WSPP) Agreement, an umbrella agreement with hundreds of signatories, which contains standardized terms that may be incorporated into "confirmation agreements" setting forth the terms of specific bilateral transactions. ER 540, 591. *See Envtl. Action v. FERC*, 996 F.2d 401 (D.C.

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[9] *See* Brief of Coral Power, L.L.C., Dynegy Power Marketing, Inc., PPM Energy, Inc., and Sempra Generation as *Amici Curiae* Supporting Petitioners at 3-4 (describing Dynegy's negotiations and contract with DWR).

Cir. 1993); *W. Sys. Power Pool*, 119 FERC ¶ 61,302 (2007). They agreed that Mirant would sell 15 MW of firm energy around-the-clock for 69 months, from April 1, 2001, to December 31, 2006, at a price of $95/MWh, with delivery in southern California. ER 723. The confirmation agreement did not contain language limiting SCWC's right to file a section 206 complaint challenging the lawfulness of the rate or limiting FERC's authority to modify it.

Mirant did not file the agreement with FERC, because FERC policy did not require marketers to file such contracts. *See* Revised Public Utility Filing Requirements, 67 Fed. Reg. 31,043, 31,058 (May 8, 2002).

3. FERC's Further Response to the Western Energy Crisis

The Commission issued its first order mitigating actual spot-market sales prices on March 9, 2001, one week before SCWC agreed to Mirant's price. The order applied to a limited number of hours in January 2001—when deficiencies in reserve generation capacity in the ISO were worst—and mitigated prices at $273/MWh. *San Diego Gas & Elec. Co.*, 94 FERC ¶ 61,245, at 61,862-63 (2001). Commissioner Massey's dissent noted that this approach allowed thousands of transactions to exceed $273. *Id.* at 61,865. Simultaneously, FERC's staff recommended that FERC continue this limited approach to spot-market mitigation after May 1, 2001, and terminate all price mitigation within one year. ER 770-779.

In two incremental steps, FERC rejected that recommendation. On April 26, 2001, it ordered prospective mitigation of ISO spot-market prices in an expanded number of reserve-deficiency hours. *San Diego Gas & Elec. Co.*, 95 FERC ¶ 61,115, at 61,351 (2001)

(April 26 Order). Finally, on June 19, 2001, FERC (1) ordered prospective mitigation of spot prices around-the-clock, (2) extended this condition from California throughout the western United States, (3) extended it in time through September 2002, and (4) imposed a "must offer" condition on power suppliers to prevent the withholding of capacity from the market. JA 672a, 682a-685a (June 19 Order). The Commission concluded that forward contract prices had dropped in part due to "the mitigation plan adopted in our April 26 Order." JA 676a. But, as FERC explained in a later order, despite the "additional, incremental steps taken in the April 26 Order to ensure just and reasonable rates and adequate supply," it was "concerned that markets remained dysfunctional in all hours." JA 1028a. It noted that "during March 2001, there were indications that prices in non-emergency periods did not reflect competitive markets," and concluded that even "during non-emergency periods . . . , the incentive to bid high prices remained." *Id.*

The Commission later concluded that "the effect of the [June 19 Order's] West-wide mitigation was to stabilize prices." JA 1145a.

On July 25, 2001, FERC employed the June 19 Order's mitigation plan as the framework to mitigate prices and order refunds around-the-clock in the ISO and PX spot markets back to October 2, 2000. *San Diego Gas & Elec. Co.*, 96 FERC ¶ 61,120 (2001). The order did not require refunds for sales outside these spot markets but reaffirmed that parties could file complaints: "If DWR (or any other party) believes any of its contracts are unjust and unreasonable, it may file a complaint under FPA Section 206 to seek modification of such contracts." *Id.* at 61,515 n.59.

On December 19, 2001, FERC declined to order blanket mitigation of prices in future or past long-term power contracts, leaving complaint proceedings as the only avenue for relief. It denied requests by SCWC and other parties that it broaden its prospective price mitigation beyond the spot markets, finding that its mitigation of spot-market prices would automatically affect forward markets:

> Applying mitigation to spot market transactions results in mitigation of generation market power in forward markets by creating a kind of competitive "standard offer" service for customers. If sellers attempt to charge excessive, non-competitive prices in forward markets, customers can avoid them by waiting to purchase in the real-time market. This puts market pressure on sellers to offer competitive prices in the forward markets.

JA 1021a. Despite that logic, however, FERC denied requests by SCWC and other parties that it replace the complaint procedures of its December 2000 Order with general price-mitigation relief for long-term contracts executed before FERC's final spot-market mitigation plan took effect on June 20, 2001. JA 1019a, 1022a.

4. The Proceedings at the California Commission

The California Public Utilities Commission (CPUC) regulates SCWC's rates for retail electric service. In August 2001, SCWC applied for an increase in its retail electricity rates to recover the increased costs of purchased power it was incurring under the Mirant contract and a contract it had executed with another supplier in June 2001 to purchase 8 MW

of peaking power for the next three winters (November through March) at $75/MWh, $48/MWh, and $36/MWh. SCWC calculated that the three-year weighted average cost of these purchases was $87.41/MWh.

On February 8, 2002, SCWC entered into a settlement agreement with one of its largest commercial customers and the CPUC staff. The agreement based SCWC's retail rates on a weighted average annual energy cost of $77/MWh. On July 17, 2002, in Decision 02-07-041, the CPUC approved the settlement. *In re S. Cal. Water Co.*, 2002 Cal. PUC LEXIS 326 (July 17, 2002) (CPUC Order). The settlement's higher rates increased SCWC's total annual revenues from its retail customers by 38%. *Id.* at *41 (Attachment 1, Table A). But the settlement minimized the impact on permanent residential customers by using a rate design that did not increase rates for such customers using 130% or less of a baseline energy allowance, as mandated by a 2001 California statute. *Id.* at *21. Thus, revenues from the permanent residential customer class increased by 21.5%. *Id.* at *41 (Attachment 1, Table A). But revenues from residential customers as a whole increased by 43.7%, from nonpermanent residents by 67.3%, and from commercial customers by 35.5%. *Id.* at *41-42 (Attachment 1, Tables A and B).

SCWC entered into the settlement agreement shortly after it had filed its FERC complaint regarding the Mirant contract. SCWC agreed to "act in good faith in pursuing its action against Mirant," and, if this action results in purchased power costs below $77/MWh, to file reduced retail rates. *Id.* at *45-46. The CPUC's order directs SCWC to "vigorously pursue its complaint against Mirant." *Id.* at *31.

C. FERC's Denial of the Company's Complaint

1. On December 21, 2001, SCWC filed a section 206 complaint alleging that the $95 rate in the Mirant contract was unjust and unreasonable and requesting FERC to determine the just and reasonable rate. SCWC noted that its contract, except for its rate, was almost identical with the five-year, around-the-clock energy contract for which FERC had established a $74 benchmark price. SCWC argued that the contract price was artificially inflated by market conditions when the contract was signed, before FERC's final spot-market mitigation took effect.

Mirant's answer argued, *inter alia*, that *Mobile* and *Sierra* allowed FERC to change the contract rate only under a public-interest standard.

2. The Commission set the complaint for hearing with the similar complaints by the Nevada Companies and Snohomish. JA 1080a. It limited the hearing to two issues: "whether the complainants must bear the burden of showing that a challenged contract is contrary to the public interest, or whether they will bear the burden of showing that the contract is not just and reasonable," and "whether the dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether modification of any individual contract at issue is warranted." JA 1100a, 1102a.

At hearing, Mirant offered testimony interpreting the WSPP Agreement "as a matter of contract law" to bar section 206 complaints to change the rates in WSPP transactions. Another Mirant witness acknowledged that Mirant was aware of FERC's December 2000 Order and benchmark price when it

signed the SCWC contract, ER 93-94, but he was unaware of any expectation or understanding by Mirant that the contract extinguished SCWC's rights to file a complaint seeking FERC review of the contract price. ER 457. He also testified that Mirant had calculated the levelized $95 contract price from Mirant's "forward price curves," which represented expected spot electricity prices during the contract term, and that Mirant increased its offer prices on March 15 and 16 as it updated these curves. ER 452-55. Mirant's price curves for March 14-16, 2001, showed prices that generally declined over the 2001-2006 term but were much higher in 2001 and 2002 than in 2003-2006.[10] Mirant also submitted an economist's testimony that the $95 contract price reflected prevailing market prices when the contract was signed. ER 484-85, 490.

SCWC submitted testimony by FERC's former chief economist concluding that Mirant's $95 contract price reflected Mirant's forgone expected spot-market revenues over the contract term, and that in prior orders FERC had found this direct relationship between forward-contract and expected spot prices. ER 734. He noted that Mirant's expert witnesses had conceded that this relationship existed. ER 797. He testified that because expected spot prices were artificially inflated in this case, so was the contract price: over its term, the contract overcharged SCWC $16

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[10] Mirant had separate price curves for peak hours and off-peak hours, which it combined to price an around-the-clock energy sale. For Mirant's March 16 price curves, the weighted average price for May-December of 2001 was $214; for year 2002, $108; for year 2003, $67; for year 2004, $59; for year 2005, $53; and for year 2006, $51. ER 460.

million compared to FERC's benchmark price. ER 799.

3. The ALJ adopted Mirant's interpretation of the WSPP Agreement, Pet. App. 84a-87, and held that FERC therefore could change the contract rates only under a public-interest standard of review, *id.* at 209a, 245a, which imposed a "high burden" and had been described as "practically insurmountable," *id.* at 209a-210a. The ALJ concluded that SCWC did not meet that standard, because the contract did not cause SCWC such "financial hardships" that it might be unable to "continue doing business" and did not cause SCWC's retail customers to bear an "excessive burden." *Id.* at 214a-215a.

The ALJ found that "changes in market fundamentals and competitive conditions drove spot and forward markets." *Id.* at 109a. *See also id.* at 115a, 117a, 119a. The ALJ also found that "the relationship between price determination in spot and forward markets, especially long-term bilateral markets, is attenuated," and thus "it is not credible that dysfunctions in the California spot markets would have significantly affected the rates, terms, or conditions of the forward, fixed price contracts at issue in this proceeding." *Id.* at 135a.

4. While FERC was reviewing the initial decision, its staff in March 2003 issued its Final Report on Price Manipulation in Western Markets (Staff Final Report). JA 1sa. The staff reported its findings of pervasive manipulation of electric and gas markets in the western United States in 2000-2001. The report also concluded that "forward power contracts negotiated during the period 2000-2001 in the western United States were influenced by then-current spot prices, presumably because spot power prices influ-

enced buyers' and sellers' expectations of spot prices in the future." JA 190sa. The report recommended that FERC send this analysis for use by the presiding ALJs "[f]or complaints that are subject to a just and reasonable standard of review." JA 208sa.

5. By a 2-1 vote, FERC affirmed the ALJ's initial decision. JA 1222a-1299a. The Commission agreed with the ALJ's interpretation of the WSPP Agreement to require FERC to review these complaints under a public-interest standard of review. JA 1242a-1246a. But FERC did not address the ALJ's findings that the spot and forward markets had functioned properly and that there was little relationship between the two markets—or the contrary findings in the Staff Final Report. Instead, FERC deemed these issues irrelevant, because "a finding that unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a 'just and reasonable' standard of review." JA 1275a.

The Commission did not refer to its $74 benchmark price. Instead, it held that under the *Sierra* "test," the complainants had to show that the challenged contracts placed them "in financial distress so as to threaten their ability to continue service" or caused "other customers" to "bear an excessive burden." JA 1276a. It found that SCWC had not made either showing. JA 1283a-1284a. It concluded from the "totality of circumstances" that the contracts resulted from "choices voluntarily made by the Complainants" to reject "better alternatives." JA 1280a-1284a.

Commissioner Massey dissented, concluding that the just-and-reasonable standard applied and that

the spot markets had adversely affected the prices of these contracts. JA 1300a-1319a.

6. The Commission denied rehearing by the same 2-1 vote. JA 1554a-1609a. It upheld its decision to apply a public-interest standard of review, JA 1562a-1577a, and reaffirmed its findings that the Mirant contract was not contrary to the public interest, JA 1578a-1579a.

D. The Court of Appeals' Remand

The court of appeals remanded the proceedings for reconsideration. The court held that the FPA requires all rates to be just and reasonable and that *Sierra* applied this statutory standard. Pet. App. 8a-9a, 35a-36a. Rather than creating a separate public-interest standard of review, the court held, *Mobile* and *Sierra* merely support a presumption in some cases that a wholesale power rate established by contract is just and reasonable for the contract's entire term. *Id.* at 9a. From the "context of *Mobile-Sierra* and from later cases," *id.* at 10a, the court concluded that three prerequisites are necessary to establish a presumption that a contract rate is just and reasonable for its entire term:

> (1) the contract by its own terms must not preclude the limited *Mobile-Sierra* review; (2) the regulatory scheme in which the contracts are formed must provide FERC an opportunity for effective, timely review of the contracted rates; and (3) where, as here, FERC is relying on a market-based rate-setting system to produce just and reasonable rates, this review must permit consideration of all factors relevant to the propriety of the contract's formation.

Id.; *see also id.* at 35a-42a.

As to the first point, the court concluded that the contracts at issue did not preclude such a presumption. *Id.* at 42a-46a.[11]

The court then held that FERC's procedures for granting market-based rate authority and monitoring market-based rate transactions during 2000-2001 did not justify a presumption that these contract rates were just and reasonable. *Id.* at 46a-57a. The court noted that FERC had pledged in its December 2000 Order "to oversee the forward market contracts to ensure their justness and reasonableness." *Id.* at 50a. But FERC then ruled that because it had granted the sellers market-based rate authority, it could presume their resulting contracts were just and reasonable "without any direct inquiry into whether the resulting rates were in fact 'just and reasonable,' and also without any inquiry into the actual state of the market at the time contracts were negotiated." *Id.* at 51a. Because of these "flawed processes," FERC rendered itself unable to provide the market oversight it had pledged to provide. *Id.* at 56a-57a.

The court further held that FERC erred in presuming the contracts were just and reasonable without regard to the market conditions when these contracts were negotiated. *Id.* at 57a-60a. Instead, the court found, FERC held that evidence about market conditions, including that in the Staff Final Report, was

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[11] Although stating that it was "uphold[ing]" FERC's interpretation of the WSPP Agreement as "reasonable," *id.* at 46a, the court specifically did "not rely on" FERC's finding that the WSPP Agreement affirmatively waived the buyer's rights to file a section 206 complaint, *id.* at 43, but held that it was sufficient that the contract lacked a specific reservation of rights to file such a complaint, *id.* The Commission does not challenge the court's disposition of this issue.

"irrelevant" *because* a *Mobile-Sierra* presumption of the lawfulness of the rates applied. *Id.* at 58a. Thus, "FERC failed ever to consider whether the influence of the spot markets on the forward markets reached a level sufficient to question whether FERC could assume that two private parties had negotiated a 'just and reasonable' contract in the first instance . . . ." *Id.*

Finally, the court held that even if a presumption that these contracts were just and reasonable could be applied here, FERC had used an erroneous analysis of the public interest in denying the complaints. The court held that *Sierra* addressed a particular set of facts—a rate that was alleged to be too low—and did not impose "a three-prong public interest standard applicable across all circumstances." Pet. App. at 62a. In particular, the court held, *Sierra* did not erect an "excessive burden" standard apart from the statutory just-and-reasonable standard. *Id.* at 63a. Because FERC had relied on that flawed "excessive burden" analysis in denying the complaint, a remand was necessary. *Id.* at 65a-66a.

SUMMARY OF ARGUMENT

This case should have been straightforward. The Commission pledged "vigilant" oversight to ensure that long-term contract prices were just and reasonable while California's load shifted to the forward market. Rather than prescribe price controls, FERC relied on complaints and adopted a benchmark contract price to evaluate them. Except for its 28% higher price, SCWC's contract was nearly congruent with FERC's benchmark contract. But FERC denied SCWC's complaint by deeming the market conditions, its benchmark price, and even the statute's just-and-

reasonable standard to be irrelevant, and by holding that the contract rate was lawful because it was not contrary to the public interest.

1. a. This action contravened the statutory directive to determine just and reasonable rates. The Commission used an erroneous standard that on its face allows excessive rates and does not test rates against FERC's established just-and-reasonable benchmark of competitive market prices. In its brief to this Court, FERC contends for the first time that it applied the just-and-reasonable standard. But the orders do not support that reading, and counsel's *post hoc* rationale is unavailing.

b. The *Mobile* and *Sierra* decisions did not authorize FERC to disregard the statute. The petitioners, Mirant, and their supporting *amici* argue that the FPA presumes the lawfulness of the rates in all wholesale electricity contracts. But the statute, its history and purpose, and this Court's decisions provide *no* support for that far-reaching argument. *Mobile* and *Sierra* applied the just-and-reasonable standard, not an alternative public-interest standard, and did not limit FERC's obligation to determine just and reasonable rates. This Court's later cases have not broadened the scope of the Court's 1956 decisions.

c. Indeed, *Mobile* and *Sierra* were inapplicable to the issues in this case. The Court's statutory construction in *Mobile* and *Sierra* assumes that the statutory procedures for Commission rate regulation adequately protected the public interest—the consuming public—when a contract rate becomes a legal, filed rate. But the allegations in SCWC's complaint, and the issues FERC set for hearing, placed at issue whether competition adequately protected customers

by holding prices to just-and-reasonable levels when this contract was executed. In applying *Mobile* and *Sierra* to alter the standard for deciding this case, FERC assumed the answer to the very question it was required to decide.

The court of appeals correctly held that FERC erred by invoking *Mobile* and *Sierra* to apply a higher standard of review, replacing the just-and-reasonable standard, to decide this case. It is undisputed that FERC cannot deregulate the rates for the sale of electricity under its jurisdiction; it may allow public utilities to charge market-based rates only if there is a regulatory mechanism to monitor the rates to ensure they are just and reasonable and to check the rates if they are not. The Commission's December 2000 Order made that protection explicit by pledging that FERC would monitor the prices of long-term contracts in California and rely on complaints to ensure their lawfulness. In the orders on review, however, FERC eliminated that regulatory backstop. The court of appeals correctly held that FERC could not interpose *Mobile* and *Sierra* to effect an unlawful deregulation of market-based rates.

The court of appeals was also correct to remand so that FERC could evaluate whether the market conditions when these contracts were formed allow FERC to presume that the contract rates were lawful. The Commission's decision that *Mobile* and *Sierra* rendered the actual market conditions irrelevant to its consideration of the lawfulness of the contract rates was contrary to FERC's statutory obligation to ensure just and reasonable rates.

2. Even if FERC's orders are construed to have applied the statutory standard and properly invoked *Mobile* and *Sierra*, FERC's findings underlying its

denial of SCWC's complaint—contrary to FERC and Mirant's contentions here—were unreasonable and not supported by substantial evidence.

a. The Commission found that the $95 contract rate did not place an "excessive burden" on SCWC's retail customers. But FERC never defined "excessive burden" or related it to the statute's standard for the lawfulness of rates. Neither did FERC explain why the undisputed 38% higher rates that SCWC's retail customers have paid, largely because of the Mirant contract, can be disregarded as not excessive.

b. The Commission's finding that SCWC profited from reselling purchased power was erroneous. The sale occurred because the first month of the Mirant contract overlapped with the last month of SCWC's Dynegy purchase contract. SCWC credited the sale revenue to its customers, but the revenue paled beside the excessive prices SCWC was paying for the long-term Mirant purchase.

c. The Commission's conclusion that SCWC chose this contract over "better alternatives" was contrary to the undisputed evidence submitted by both parties that the contract's $95 price reflected the prevailing market price in March 2001. There were no cheaper market alternatives until FERC later stabilized prices. The only "better alternative" FERC identified was *not to purchase* in the uncompetitive market in March 2001.

ARGUMENT

I. THE COMMISSION'S ORDERS CONTRAVENED THE STATUTORY DIRECTIVE TO ESTABLISH JUST AND REASONABLE RATES.

A. The Federal Power Act contains only one standard by which FERC may determine the lawfulness of rates within its jurisdiction—they must be just and reasonable.

By its terms, the FPA requires FERC to ensure all rates within its jurisdiction are just and reasonable. Section 205 provides that all "rates and charges" of a public utility for wholesale electric energy "shall be just and reasonable" and declares any such rate or charge "that is not just and reasonable" is "unlawful." 16 U.S.C. § 824d(a). Section 206 requires that "[w]henever" FERC, "upon complaint," finds that such a rate, charge or "contract" is "unjust, unreasonable, unduly discriminatory or preferential," FERC "shall determine the just and reasonable rate, charge, . . . or contract to be thereafter observed and in force, and shall fix the same by order." *Id.* § 824e(a). Section 206 is cast in mandatory language; upon finding a rate or contract to be unlawful, the Commission "must determine and fix by order 'the just and reasonable rate.'" FERC Br. at 3 (quoting section 206(a)). *See also* Brief of Morgan Stanley Capital Group Inc. (MSCG) at 42 ("Once FERC concludes that a rate is unjust and unreasonable, FERC must reform the rates.").

The court of appeals held that that the "FPA establishes a single, albeit general standard for FERC's adjudication of contract challenges like the present

one: whether the challenged contract is 'just and reasonable.'" Pet. App. 9a n.7 (quoting section 206(a)). The Commission and Morgan Stanley expressly concede the correctness of that holding, FERC Br. at 21; MSCG Br. at 7 n.4, and the Calpine petitioners and respondent Mirant do not challenge it.

The court of appeals' holding was entirely correct in any case. The statute is unambiguous, and *Sierra* applied the unjust-or-unreasonable standard of section 206(a)—not an alternative, extra-statutory "public interest standard of review." The Court held that, assuming the FPC had made "a finding of [the] unreasonableness of the contract rate," such "conclusion appears on its face to be based on an erroneous standard." *Sierra*, 350 U.S. at 354. But the "erroneous standard" was *not* the unjust-or-unreasonable standard in section 206(a); instead, it was the FPC's determination that the rate was "either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Id.* at 355. Thus, the only "public interest standard" in *Sierra* and the FPA is the requirement that FERC have a public-interest basis whenever it finds a rate—whether contractually set or not—to be "unjust, unreasonable, unduly discriminatory or preferential" under section 206(a) and determines the just-and-reasonable rate. Nothing in *Sierra* allows, much less requires, departure from the statutory standard when FERC reviews the lawfulness of jurisdictional rate contracts.

B. The Commission did not apply the statutory just-and-reasonable standard to decide this case.

1. Despite the statute's unambiguous mandate and *Sierra*'s straightforward construction of the statute, FERC did not evaluate the lawfulness of the contract

rates in these cases using the just-and-reasonable standard. That flaw is apparent on the face of FERC's orders. Because it was *not* applying the just-and-reasonable standard to these cases, FERC deemed irrelevant the evidence in the Staff Final Report about the pervasive manipulation of the markets that occurred in 2000-2001 and the effect that excessive spot-market prices had on the prices of forward contracts formed during that period:

> [A] finding that the unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a "just and reasonable" standard of review. . . . Under the "public interest" standard, to justify contract modification *it is not enough to show that forward prices became unjust and unreasonable* due to the impact of spot market dysfunctions; *it must be shown that the rates, terms, and conditions are contrary to the public interest.*

JA 1275a (emphasis added). Accordingly, FERC made no finding as to whether Mirant's $95 contract rate was just and reasonable.

This error was so egregious that *the sellers* asked FERC to clarify that this public-interest standard of review does not permit unjust and unreasonable rates under the FPA.[12] The Commission rejected this advice and confirmed beyond cavil its legal error with this restatement of the decisional rule it had employed here:

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[12] The sellers seeking this clarification included three of the petitioners in Nos. 06-1457 and 06-1462 as well as respondent Mirant. ER 356A-356H.

> [I]f rates subsequently become unjust and unreasonable and the contract at issue is subject to the Mobile-Sierra standard of review, the Commission under court precedent may not change the contract simply because it is no longer just and reasonable. If parties' market-based rate contacts provide for the public interest standard of review, the Commission is bound to a higher burden to support modification of such contracts.

JA 1567a. This error was more than a failure to "expressly mention the just-and-reasonable standard." *FPC v. Texaco, Inc.*, 417 U.S. 380, 396 (1974). Here, FERC expressly repudiated that standard.

2. The Commission argues that its orders should be sustained as a reasonable interpretation and application of the FPA's just-and-reasonable standard, which it "interpreted . . . to provide for a narrow review" in this case—"limited to determining whether the rates are contrary to the public interest." FERC Br. at 19. That argument marks the first time in this long litigation that FERC has claimed that it applied the just-and-reasonable standard to decide these cases. In the court of appeals, FERC argued that the just-and-reasonable standard did not apply. Brief of Respondent FERC, 9th Cir. Nos. 03-74208 *et al.*, at 82 (Sept. 22, 2004) ("the issue here is not whether the contract rates were unjust and unreasonable").

In any event, however, FERC's orders are not susceptible of the construction that it now places on them. The passages quoted above are not isolated instances in orders that generally adhere to the statutory formula. To the contrary, the orders state that *Mobile* and *Sierra* required FERC to use a "public interest standard of review," which the orders

nowhere describe as an *application of* the statutory just-and-reasonable standard, but rather as something *different from* the statutory standard. JA 1225a, 1228a-1229a, 1235a-1236a, 1286a, 1562a-1575a.

The orders cannot be sustained as an exercise of discretion that FERC itself believed it lacked and did not assert. *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168-69 (1962); *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947).

3. The Commission's error was not just semantic; it replaced the statutory standard with unrelated and inconsistent tests.

a. The orders on review primarily purported to use the "*Sierra* Three-Prong Test." JA 1276a, 1577a. But the two "prongs" that FERC applied here were unrelated to *Sierra* or the statutory just-and-reasonable standard—and facially inadequate to protect the public interest as defined in the FPA.

The first "prong"—whether the contract rates were "placing the Complainants in financial distress so as to threaten their ability to continue service," JA 1276a—had no relation to the statutory standard of reasonableness, *see Permian Basin Area Rate Cases*, 390 U.S. 747, 790-92 (1968); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Nothing in the FPA, *Sierra*, or the case law suggests Congress' tolerance for excessive rates until they threaten a *purchasing* utility's ability to provide service. Under the FPA, a rate may be "unjust" or "unreasonable"—*i.e.*, excessive to consumers and thus against the public interest—even if the purchasing utility is able to pass on the costs and continue service. The Commission brief essentially concedes error on this point. FERC Br. at 41-42 ("the insolvency of a seller

is obviously an issue in a low rate case, see *Sierra*, 350 U.S. at 355, but insolvency is not necessarily a concern in a high rate case, such as where a purchaser can pass high rates on to its customers without going bankrupt").

The orders never define the second "prong"—that the contract "impose an excessive burden" on the purchasing utility's customers. JA 1277a-1278a. On rehearing FERC resorted to a circular definition: "The public interest test requires a showing that the contract places an excessive burden on ratepayers sufficient to modify the contract." JA 1578a-1579a. Given the FERC's failure to explain this excessive-burden test and relate it to the statutory standard of lawfulness, the court of appeals was right to remand the matter for reconsideration. *See Texaco,* 417 U.S. at 395-96.

On its face, however, FERC's excessive-burden test was contrary to the statute and case law. As the court of appeals correctly recognized, *see* Pet. App. 63a, the "excessive burden" in *Sierra* arose from cost shifting: if a rate charged to one wholesale purchaser is too low, the seller may increase rates charged to other purchasers and thus "cast upon other consumers an excessive burden." 350 U.S at 355. That concept accords with the statutory just-and-reasonable standard, under which FERC normally requires that customer rates "fairly track the costs for which they are responsible." *Pa. Elec. Co. v. FERC,* 11 F.3d 207, 211 (D.C. Cir. 1993); *see also Town of Norwood v. FERC*, 962 F.2d 20, 25 (D.C. Cir. 1992); Alfred J. Kahn, The Economics of Regulation 66, 78, 83, 89, 150-52 (MIT Press 1988) (1970).

Here, by contrast, FERC articulated no statutory nexus for its excessive-burden test. An "excessive

burden" appears to mean *grossly* excessive rates, well beyond "unjust" or "unreasonable." But FERC's orders—and now its brief—identify nothing in the statute suggesting a congressional judgment that the public interest allows rates to approach grossly excessive levels. The statute "makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted." *Texaco*, 417 U.S. at 399. By its excessive-burden test, FERC "has abdicated its statutory responsibilities in favor of a method that, by its own description, guards against only grossly exploitative pricing practices." *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1503-04 (D.C. Cir. 1984).

The Commission brief concedes that *Sierra*'s reference to an "excessive burden" on "other customers" is "inapplicable" in a case where a wholesale buyer complains that a rate is too high. FERC Br. at 39-40 n.4. Nonetheless, FERC asserts that "there is no reason to substitute some less demanding and more ambiguous standard for the excessive-burden test." *Id.* But there is a good reason: the just-and-reasonable standard is in the statute, and the "excessive-burden test" is not. Moreover, it is hard to conceive of a standard "more ambiguous" than FERC's non-statutory, still-undefined "excessive-burden test." By contrast, the statutory just-and-reasonable standard is well defined by decades of judicial and agency decisions. The Commission has made no case for dispensing with the statutory standard for one of its own choosing.

b. The Commission rehearing order suggested that even apart from "the three-prong *Sierra* test," the "totality of the circumstances" might justify abrogating or modifying a contract in some circumstances.

JA 1591a. But again FERC substituted a test of its own for the statutory just-and-reasonable standard. The orders address the circumstances surrounding the formation of these contracts and deny the complaints, primarily upon concluding that the contracts were voluntary and that the buyers had alternatives to signing them. JA 1584a-1593a. But the orders never find, much less make a reasoned and supported finding, that these circumstances demonstrated the presence of competitive market forces such that FERC could presume that the contract rates were just and reasonable, as the statute and case law require. *See Lockyer*, 383 F.3d at 1012-13; *La. Energy & Power Auth.*, 141 F.3d at 365. Indeed, FERC deemed *irrelevant* the findings of the Staff Final Report regarding the market conditions in which these contracts were negotiated. Thus, FERC never explained how its "totality of the circumstances" inquiry was tied to the statutory just-and-reasonable standard. "In the absence of an explanation, the 'totality of the circumstances' can become simply a cloak for agency whim—or worse." *LeMoyne-Owen College v. NLRB*, 357 F.3d 55, 61 (D.C. Cir. 2004) (Roberts, J.).

4. Thus, the standard of review used in FERC's orders to deny the complaints "rests on reasoning divorced from the statutory text." *Massachusetts v. EPA*, 127 S. Ct. 1438, 1462 (2007). Congress declared in section 201(a) of the FPA, 16 U.S.C. § 824(a), that federal regulation of wholesale electricity rates "is necessary in the public interest." That declaration properly informs FERC's discretion as it applies the statute. *See Sierra*, 350 U.S. at 355. But it "is not a roving license to ignore the statutory text." *Massachusetts v. EPA*, 127 S. Ct. at 1462. Here, however, FERC used that declaration of statutory purpose to

contravene the statutory directive to determine just and reasonable rates. The case was properly remanded to FERC, which "must ground its reasons for action or inaction in the statute." *Id.* at 1463.

C. The statute does not presume that wholesale electricity prices are lawful if they are in a contract.

In an attempt to excuse FERC's failure to make the findings required by the statute, the petitioners, Mirant, and their supporting *amici* argue that, by virtue of *Mobile* and *Sierra*, the rates in privately negotiated contracts subject to the Commission's regulatory jurisdiction under the FPA and NGA are presumptively lawful—even in the absence of any prior FERC review, and irrespective of the regulated seller's costs or the competitiveness of the market in which the contracts are formed. *See* MSCG Br. at 6; Calpine Br. at 1, 40; Coral Br. at 9-14; Brief of Electric Power Supply Association (EPSA) *et al.* at 8-17; Brief of International Swaps and Derivatives Association, Inc. at 7-15. The Commission defends its approach in similar terms, arguing that no prior review or after-the-fact oversight of the contract rates was required before *Mobile* and *Sierra* allowed it to presume the contract rates' lawfulness. *See* FERC Br. at 33.

But there is *no* support in the statutory language, the pertinent legislative history, or the decisions of this Court for a presumption of lawfulness of all privately negotiated contracts subject to FERC's regulatory jurisdiction. To the contrary, in both the FPA and the NGA, Congress rejected such a presumption by making such contracts subject to Commission regulation.

1. Sections 205 and 206 of the FPA contain no hint that all contract rates are presumptively lawful. Under the statute, the existence *vel non* of a private contract does not alter the test of the reasonableness of the rate or affect FERC's regulatory authority to review and modify the rate. Section 205(a) requires that "all" rates be just and reasonable, whether they are established by contract, tariff, or FERC order fixing the rate under section 206(a). Section 205(c) requires that all rates, including all rate contracts, be filed with FERC precisely so that FERC may review and, if necessary, modify them. The statute "permits the relations between the parties to be established initially by contract, the protection of the public interest being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public." *Mobile*, 350 U.S. at 339. Similarly, section 206(a) by terms requires FERC to "determine the just and reasonable rate, charge, . . . or contract to be thereafter observed and in force" and "fix the same by order." It places no limit on FERC's power to modify a contract rate as opposed to a rate established by unilateral filing.

Section 205 does not require FERC to conduct a hearing and approve every filed rate before it can become the legal rate. But, contrary to EPSA's suggestion, EPSA Br. at 8-13, that feature of section 205 does not confer a presumption of lawfulness on contract rates. The same filed-rate procedure is used for all rates, whether established by a unilateral tariff filing or by contract. *See id.* at 20-21. Nothing in the statutory filed-rate procedure suggests a presumption of lawfulness of all jurisdictional rates.

2. The statutory purposes and legislative history of the FPA and NGA—confirmed by the decisions of this

Court—preclude any reading that would render all jurisdictional contract rates presumptively lawful. Congress enacted sections 205 and 206 of the FPA in 1935 "in the context of, and in response to, great concentrations of economic and even political power" and intended "to curb abusive practices of public utility companies by bringing them under effective control, and to provide effective federal regulation of the expanding business of transmitting and selling electric power in interstate commerce." *Gulf States*, 411 U.S. at 758. *See* S. Rep. No. 74-621, at 1-4, 17-20 (1935). Because important aspects of the sale and transmission of electric energy were viewed as beyond effective regulation by the states, Congress enacted the FPA to provide effective federal regulation. *See FPC v. S. Cal. Edison Co.*, 376 U.S. 205, 212-13 (1964); *Jersey Central Power & Light Co. v FPC*, 319 U.S. 61, 67-68 (1943). In doing so, Congress intended that the FPA would apply traditional principles of public-utility regulation. *See* S. Rep. No. 74-621, at 18 ("Part 2 places the utilities under the regulated conditions which have been prescribed for the principal other national utilities. . . . The sale price of energy sold at wholesale in interstate commerce is made subject to Commission determination."). Given this history, if Congress, in allowing rates to be established by contract, had also intended that such contract rates be subject to narrow regulatory review or be presumptively lawful, one would think there would be some mention of this fact in the relevant provisions of the legislative history.

In enacting the NGA, "Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas." *Texaco*, 417 U.S. at 397. Section 1 of the NGA refers to reports by the

Federal Trade Commission (FTC) as the basis for the finding that federal regulation "is necessary in the public interest." 15 U.S.C. § 717. This Court has summarized the FTC's findings as follows:

> The major impetus for the congressional grant of sales jurisdiction to the FPC was furnished by a Federal Trade Commission study of the pipeline industry in 1935-36. The study showed that increasing concentration in the industry was producing vast economic power for the pipelines and a serious threat of unreasonably high prices for consumers. This threat was most acute in the case of sales for resale because wholesale distributors and their customers had little economic clout with which to obtain equitable prices from the pipelines.

FPC v. La. Power & Light Co., 406 U.S. 621, 638-39 (1972). The FTC's final report concluded that "the ownership and control of the major pipe lines of the entire country east of the Rockies are rapidly being concentrated in the hands of four groups which are so closely interrelated as to constitute for all practical purposes a single interest of enormous economic power." S. Doc. No. 70-92, Part 84-A, at 592 (1936). Because the "interstate pipe-line companies, which form the great part of the natural-gas pipe-line industry, are at present virtually free from regulation—certainly free from effective regulation," *id.* at 613-14, the FTC recommended that "[w]holesale rates for gas delivered in interstate commerce should be regulated *in all cases*, as the States are without power to fix them," *id.* at 614 (emphasis added). *See id.* at 615-16 (listing "specific evils existing in the natural-gas industry," including "Unregulated monopolistic control of certain natural-gas production

areas" and "Unregulated control of pipe-line transmission and of wholesale distribution"). This history rebuts any notion of a statutory presumption that pipelines' jurisdictional gas sales contracts were reasonable and lawful.

3. The petitioners, Mirant, and their supporting *amici* nonetheless attempt to locate a presumption of lawfulness of FERC-jurisdictional rate contracts in the decisions of this Court. But their arguments rest on snippets of dictum taken out of context and a misreading of the cases.

a. First, they read far more into *Mobile* and *Sierra* than either case will bear. Both cases recognize the supremacy of the statute over contracts. *See Mobile*, 350 U.S. at 344 ("contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest"); *Sierra*, 350 U.S. at 353 ("The Commission has undoubted power under § 206(a) to prescribe a change in contract rates whenever it determines such rates to be unlawful."). Moreover, as already noted, *Sierra* did not replace the just-and-reasonable standard for jurisdictional rate contracts; it *applied* that standard.

The petitioners contend that the FPC accepted the contract rates in *Mobile* and *Sierra* without formally approving them—as if that somehow supports a presumption that all negotiated rate contracts are presumptively lawful, whether or not they are reviewed by FERC or even filed with it. MSCG Br. at 41; Calpine Br. at 40 n.7; *cf.* FERC Br. at 33 (arguing that prior review is unnecessary). Neither case supports the suggested conclusion. *Mobile* states that the filed contract became part of the pipeline's rates "with the approval of the Commission." 350 U.S. at 336. And *Sierra* notes that the contract was "duly

filed." 350 U.S. at 352. In both cases, therefore, if the reasonableness of the contract rates had been drawn into question, the FPC had the opportunity to judge it, which is "the clear purpose of the congressional scheme." *Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 582 (1981) (*Arkla*). Moreover, the FPC's acceptance of these contract rates did not subject consumers to privately negotiated, market-based rates. In *Mobile*, the 1946 contract rate between the pipeline and the distributing company was defined as a percentage of the distributing company's state-approved retail rate; in 1952, the FPC ordered the pipeline to change the contract rate from a percentage rate to an equivalent fixed rate. *See Mobile Gas Serv. Corp. v. FPC*, 215 F.2d 883, 884 (3d Cir. 1954), *aff'd sub nom. United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956). In *Sierra*, the contract rate was a cost-of-service rate approved by the CPUC for the selling utility's sales to certain of its wholesale customers in California. *See Sierra Pac. Power Co. v. FPC*, 223 F.2d 605, 606 (D.C. Cir. 1955), *aff'd*, 350 U.S. 348 (1956).[13] This rate was designed to enable the utility to retain the existing business of these customers, and it came with the condition that the utility's shareholders—not its other customers—would bear the financial burden of the lower rate. *Id.* The contract rate in *Sierra* was not, therefore, a market rate, much less an "aberrational" market rate, *see* Calpine Br. at 48.

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[13] At the time, it was believed that the CPUC had regulatory jurisdiction over wholesale sales within California. In *S. Cal. Edison*, 376 U.S. 205, the Court held that the FPC had exclusive jurisdiction over all wholesale sales in interstate commerce, including sales to customers within the state.

b. This Court's later decisions do not suggest any broader interpretation of *Mobile* and *Sierra*, from which the presumption of lawfulness for privately negotiated contracts might be inferred. To the contrary, this Court's decisions confirm that a determination under the FPA that a contract rate is just and reasonable must arise from something beyond the fact of contracting—namely, from the operation of the statutory scheme for the utility's filing and FERC's review and possible modification of the rate. *See Wisconsin v. FPC*, 373 U.S. 294, 304 (1963) (contract price-escalation clause only allowed producer to file the higher rate; "producer must still establish its lawfulness wholly apart from the terms of the contract"); *see id.* at 331 (Clark, J., dissenting) (relying on quoted language).

Thus, in *Permian Basin*, the Court upheld the FPC's *abrogation* of contract prices that exceeded the cost-based area maximum rates. 390 U.S. at 783-84. The Court observed that section 5(a) of the NGA "provides without qualification or exception" the authority to determine a just-and-reasonable contract rate. *Id.* Citing *Mobile*, the Court noted that the NGA "is premised upon a continuing system of private contracting," but citing *Sierra*, it also noted that "the Commission has plenary authority to limit or to proscribe contractual arrangements that contravene the relevant public interests." 390 U.S. at 784. The Court thus upheld the FPC's abrogation of contracts to enforce the just-and-reasonable standard. In fact, in the order reviewed in *Permian Basin*, the FPC rejected the position that privately negotiated contracts should be considered lawful, finding that anti-

competitive conditions in the market precluded that conclusion.[14]

The petitioners and FERC quote the Court's later statement in *Permian Basin* that the NGA allows the abrogation of private contracts "only in circumstances of unequivocal public necessity," 390 U.S. at 822. *See* MSCG Br. at 30; Calpine Br. at 33, FERC Br. at 17, 22, 38. But the Court made that statement in the context of upholding the FPC's refusal to *increase* the area maximum rate to account for the fact that some contracts contained prices below that rate. That holding was a straightforward application of *Sierra*, which the Court cited. *See Permian Basin*, 390 U.S. at 821. *Permian Basin*, in short, provides no support for the petitioners and their supporters.

Morgan Stanley and FERC cite the Court's statement in *Arkla* that FERC "lacks affirmative authority, absent extraordinary circumstances, to 'abrogate

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[14] "[T]here is nothing in the record which would justify a conclusion that reliance on contract prices unrelated to cost will 'afford consumers a complete, permanent and effective bond of protection from excessive rates and charges,' . . . . There are admittedly many producers selling gas to the interstate pipelines both in the nation as a whole and the Permian Basin in particular; but nothing in this record suggests that any competition among them in making sales to the pipelines is in any way adequate to assure that the public will secure gas at just and reasonable prices in the absence of regulation." *Area Rate Proceeding*, 34 FPC 159, 181 (1965) (*quoting Atl. Refining Co. v. Pub. Serv. Comm'n of N.Y.*, 360 U.S. 378, 388 (1959)), *aff'd in relevant part sub nom. Skelly Oil Co. v. FPC*, 375 F.2d 6 (10th Cir. 1967), *aff'd sub nom. Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). *See id.* at 183 ("Whatever the degree of competition which may exist among producers it has not been effective to afford consumers the protection to which they are entitled under the Natural Gas Act.").

existing contractual arrangements.'" 453 U.S. at 582 (quoting *Permian Basin*, 390 U.S. at 820). *See* MSCG Br. at 30; FERC Br. at 22. But far from diminishing the importance or the scope of FERC's regulatory authority, *Arkla* held that FERC's opportunity to review the reasonableness of rate contracts was so important "in the federal scheme for regulating the sale of natural gas" that the seller could not be permitted to charge an unfiled contract rate. 453 U.S. at 582. *Arkla* is thus inconsistent with a construction of the statutory scheme that would presume contract rates are lawful.

The petitioners, Mirant, and FERC cite the Court's observation in *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 479 (2002), that wholesale sellers and buyers "were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." *See* MSCG Br. at 30-31, 32, 43; Calpine Br. at 34, 39; FERC Br. at 22, 34. But the Court did not undertake to define when this presumption or expectation would be warranted by the facts, properly leaving that determination to the regulator. *Verizon* recognized that the FPC historically relied on cost-of-service regulation. 535 U.S. at 481-85. When FERC permits market-based wholesale electric rates, however, it does not presume "equal bargaining power," but requires the seller to demonstrate that it lacks or has mitigated its market power. Nothing in *Verizon* suggests that the FPA rests on a legislative presumption that such equal bargaining power exists so as to excuse the need for effective regulation.

Lacking support in the statutory language, the legislative history, or the past decisions of this Court,

the argument for the presumptive lawfulness of all wholesale electricity contracts should be rejected.

D. The Commission erred in invoking *Mobile* and *Sierra* to supplant the statutory just-and-reasonable standard for deciding this case.

The complaints in this case do not threaten the interests in contractual stability recognized in *Mobile* and *Sierra*. The Commission's December 2000 Order pledged vigilant market oversight and provided for complaint procedures to ensure that a particular class of contracts would be just and reasonable. SCWC filed its complaint pursuant to that order. Adjudicating the complaint in accordance with the procedures and standards FERC had prescribed—including the just-and-reasonable benchmark price—is fully consistent with *Mobile* and *Sierra* and would not undermine the stability of contracts generally. Contrary to FERC's view, *Mobile* and *Sierra* did not allow, much less require, FERC to substitute its public-interest standard of review for the statutory just-and-reasonable standard in judging SCWC's complaint.

The court of appeals found two reasons why FERC's decision in this case "create[d] a gap in the FPA's protection against excessive energy prices." Pet. App. 3a. Both points are valid, and FERC's counter-arguments in its brief are unconvincing.

1. First, the court of appeals held that "FERC failed to adopt any monitoring mechanism before applying deferential *Mobile-Sierra* review to the challenged contracts," pointing in particular to FERC's failure to provide the monitoring promised in its December 2000 Order. Pet. App. 50a-51a. The court

concluded that such monitoring and oversight of rates is essential to the lawfulness of FERC's market-based rate regime. Pet. App. 46a-50a. That conclusion was in accord with prior cases, which have uniformly upheld market-based rates only when FERC has a regulatory "escape hatch" or "safeguard" mechanism to keep rates just and reasonable if actual competitive pressures prove insufficient. *La. Energy & Power Auth.*, 141 F.3d at 370-71. *See also Lockyer*, 383 F.3d at 1012-13; *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993); *Farmers Union*, 734 F.2d at 1509.

The Commission contests neither the need for adequate oversight of market-based rates nor the deficiency of its market oversight in California in 2000-2001. It only notes that it has improved such oversight since then. *See* FERC Br. at 30-31. It argues, however, that none of that matters, and no particular form of market oversight or prior review of the contract rates in this case was required, because *Mobile* and *Sierra* apply of their own force. *See* FERC Br. at 33 ("An imperfection in the Commission's market oversight, standing alone, is not a sufficient basis to set aside a contract that would otherwise qualify for protection under the FPA.").

But this argument ignores what has taken place here. By applying *Mobile* and *Sierra* to require a "public interest standard of review," FERC has not just overlooked the deficiency in its market oversight—it has exacerbated the problem. Under FERC's December 2000 Order, the complaint proceeding below was part and parcel of the FERC-prescribed oversight mechanism for the rate in SCWC's contract. In that order, FERC rejected price controls in favor of vigilant market oversight *and* adjudication of individ-

ual complaint proceedings. It adopted the benchmark price to assist parties in deciding whether to file such complaints and to use in adjudicating such proceedings.

The Commission's argument wrests the *Mobile* and *Sierra* decisions from their source—this Court's construction of the statutes. *See Mobile*, 350 U.S. at 337; *Sierra*, 350 U.S. at 353, 355. The Commission argues that *Mobile* and *Sierra* somehow excuse it from performing the rate review and oversight that the FPA would otherwise require and that it explicitly ordered here. Yet, as already noted, *Mobile* and *Sierra* by terms preserved FERC's authority to abrogate or modify contracts as necessary to protect the public interest as defined in the FPA—in particular, the public's interest against unjust and unreasonable rates. *See Permian Basin*, 390 U.S. at 783-84. In *Mobile* and *Sierra*, the Court did not construe the statutory language to override the statutory procedures that operate to protect the public interest as defined by the statute. The Commission's contrary argument, if true, would place the statute at war with itself.

The Commission argues that if its oversight of markets fails, the primary remedy is to prospectively revoke the market-based rate authority of individual sellers who engage in misconduct. FERC Br. at 34-35. The petitioners and Mirant suggest that FERC could also take that step if market conditions change. Calpine Br. at 46. But FERC does *not* claim that the buyers in this case could have sought prospective revocation of sellers' market-based rate authority before signing their contracts, and the court of appeals correctly rejected that argument below. Pet App. 55a-57a. Indeed, it appears that FERC would have

rejected complaints to revoke seller's market-based rate authority because of market failure. During the crisis period, and over buyers' objections, FERC continued to *grant* market-based rate authority to California generators using its ordinary market-share analysis, while assuring buyers that the price-mitigation remedies it had ordered in the December 2000 Order and later orders would ensure just and reasonable prices. *See, e.g., Duke Energy Mohave, LLC*, 96 FERC ¶ 61,092 (2001).

The Commission argues that the court of appeals' decision undermines contract stability, because parties can never be sure "what legal regime will govern their contracts." FERC Br. at 35. But it is FERC, not the court of appeals, that created that problem in this case: its December 2000 Order provided one legal regime to govern SCWC's complaint, and the orders on review quite another. In any event, the court of appeals left FERC with ample discretion to craft prospective legal rules that will provide parties with needed regulatory certainty, without bias toward any party, consistent with respect for contract stability *and* FERC's statutory obligations to ensure just and reasonable rates. *See* FERC Brief in Opposition at 11-12, 18, 21.

The Commission concluded in its orders that the December 2000 Order "never mandated the application of the 'just and reasonable' standard of review to forward contracts." JA 1583a. But a "specific acknowledgment of the possibility of future rate change is virtually meaningless unless it envisions a just-and-reasonable standard." *Papago Tribal Util. Auth. v. FERC,* 723 F.2d 950, 954 (D.C. Cir. 1983) (Scalia, J.). By adopting a cost-based, $74 benchmark price to protect against "potentially unjust and unreasonable

rates," the December 2000 Order by terms envisioned the application of the statutory just-and-reasonable standard and the just-and-reasonable benchmark price in complaint cases involving this class of contracts. The Commission's effort to avoid applying the remedial scheme and just-and-reasonable benchmark price it had previously adopted "is worse than an exemption simpliciter" from the statutory standard, since it "retains the false illusion that a government agency is keeping watch over rates, pursuant to the statute's mandate, when it is in fact doing no such thing." *Farmers Union*, 734 F.2d at 1510 (internal quotation omitted).

2. The court of appeals also held that it was a "fundamental error" for FERC to deem evidence of market conditions when these contracts were formed to be "irrelevant to the question of *whether Mobile-Sierra* applies," and for FERC to then presume that the contract rates were just and reasonable without first examining such evidence. Pet. App. 60a. The court pointed in particular to FERC's failure to consider the findings in the Staff Final Report. Pet. App. 58a-60a.

At the outset, FERC claims it *did* consider this evidence. FERC Br. at 36. But while FERC's orders did say that FERC "took into consideration" this evidence, including the Staff Final Report, JA 1274a, FERC never cited any such evidence and made no findings. Instead, it concluded (1) that evidence about spot-market dysfunction was irrelevant since FERC had already found that spot markets were not functioning, JA 1275a; (2) evidence of the relationship between the dysfunctional spot market and the long-term bilateral market was relevant only under the just-and-reasonable standard, but it was not employ-

ing that standard, JA 1275a; and (3) there was no evidence "to support a finding that there was market manipulation specific to the long-term contracts at issue here," JA 1285a. Thus, FERC's "consideration" of the evidence consisted mainly of deeming it irrelevant to the proceeding.

The Commission suggests that the court of appeals merely had a procedural quibble—i.e., that FERC had considered the evidence of market conditions at the wrong stage of its analysis. FERC Br. at 36. But the court's holding was clear—FERC had failed to consider the evidence at all. Pet. App. 58a ("FERC held [Staff findings] irrelevant" and "FERC discarded the findings"); *id.* at 58a-59a ("FERC failed ever to consider whether the influence of the spot markets on the forward markets reached a level sufficient to question whether FERC could assume that two private parties had negotiated a 'just and reasonable' contract in the first instance and therefore apply the *Mobile-Sierra* presumption.").

The Commission argues that spot-market conditions are not a reason to set aside a forward contract absent evidence of *independent* "dysfunction or manipulation" of the forward market. FERC Br. at 44. This is a *post hoc* rationale. The FERC orders do not so conclude, and for good reason: the suggestion fails on its own terms. If the forward market was so unsoundly functioning as to taint the contracts being made, it is utterly immaterial whether the cause was internal to that market or a spillover consequence of problems in the related spot market: the contract-corrupting effect can be exactly the same.

Although the Commission concedes that spot-market conditions had an effect on forward-market prices, it claims "that cannot be a sufficient reason to

abrogate all the forward market contracts." FERC Br. at 44-45. But that argument attacks a strawman: the actual question is, when does the effect on forward-market prices become significant enough that contract abrogation *is* justified? The Commission argues that forward markets enable parties to avoid spot-market volatility. FERC Br. at 45. That may be true, but it also sidesteps the question presented here: were forward markets functioning to produce just and reasonable contract rates? That is, did the forward market, as a refuge from the spot markets, itself satisfy the legal requirements, or was FERC's section 206 role a necessary refuge from the forward market?

Similarly, FERC argues that "[i]f forward contracts can be abrogated just by pointing to distortions in the spot market, much of the value of the forward market contracts will be lost." FERC Br. at 45. But again that begs the question of whether spot-market conditions can have such an effect on forward-market substitute products that the prices of the latter are rendered unlawful under the FPA.

Thus, the substantive issue that SCWC's complaint raised and that FERC set for hearing—"whether the dysfunctional California spot markets adversely affected the long-term bilateral markets"—placed at issue the condition precedent to invoking *Mobile-Sierra*. "[T]he purpose of the *Mobile-Sierra* doctrine is to preserve the benefits of the parties' bargain as reflected in the contract, *assuming that there was no reason to question what transpired at the contract formation stage.*" *Atl. City Elec. Co. v. FERC*, 295 F.3d 1, 14 (D.C. Cir. 2002) (emphasis added) (*citing Town of Norwood v. FERC*, 587 F.2d 1306, 1312 (D.C. Cir. 1978)). By applying the *Mobile-Sierra* doctrine

ab initio, FERC assumed the answer to the very question it was to decide—whether competitive market forces operated during the contract-formation stage to hold down the contract price to just-and-reasonable levels.

II. EVEN IF THE COMMISSION'S ORDERS ARE CONSTRUED TO HAVE DETERMINED THAT THE MIRANT CONTRACT RATE WAS JUST AND REASONABLE, THE ORDERS LACKED A REASONED BASIS AND WERE NOT SUPPORTED BY SUBSTANTIAL EVIDENCE.

The Commission and Mirant contend that the Commission reasonably rejected SCWC's complaint. FERC Br. at 43-44, 46; Calpine Br. at 42-44. But their arguments merely show how unsupported, arbitrary, and capricious FERC's decision really was.

A. The Commission's conclusion that the Mirant contract did not place an excessive burden on consumers was unreasonable and unsupported.

The FERC brief asserts that the Mirant contract increased SCWC's rates by less than 8%. FERC Br. at 43-44. This is flatly contradicted by the facts and FERC's orders. The CPUC Order allowed an overall 38% increase in revenues in SCWC's retail rates, primarily because of the Mirant contract, which accounted for the vast majority of SCWC's energy purchases and energy costs. The FERC brief bases its less-than-8% assertion solely on FERC's finding that "there was no rate increase for SCWC's ratepayers who are permanent residents," JA 1278a. But that

finding was not only erroneous,[15] it also addressed just one of SCWC's retail customer classes and thus did not support FERC's assertion.

In its orders, FERC also found no "excessive burden" on SCWC's customers because "the other group of SCWC's ratepayers, owners of second homes in SCWC's service area, were to face an average monthly electric bill of $ 35.13." JA 1278a.[16] The Commission asserted that SCWC has "not shown how a $35.13 monthly electric bill amounts to an excessive burden on ratepayers." JA 1579a. But this dollar amount results from part-time residents' small monthly usage and not their low rates. ER 521.[17] It provided no basis for FERC's conclusion that the Mirant contract rate is lawful under the FPA. The notion that excessive wholesale charges are lawful if they only "make a small dent in the consumer's pocket" is contrary to the statute, which "makes unlawful all

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[15] Under the CPUC Order, electric rates for permanent residential customers did not increase only if they used less than 130% of their baseline energy usage. ER 174. *See* CPUC Order, 2002 Cal. PUC LEXIS 326 at *21, 29. Otherwise, permanent residents faced rate increases. The settlement agreement approved by the CPUC recognized that revenue from permanent residents would increase 21.5%, and their average monthly bills would increase by 12.6%. *Id.* at *41, 42 (Attachment 1, Tables A and C).

[16] The order also erroneously implies that SCWC has only two classes of retail customers, all of them residential. The CPUC Order shows that is not the case.

[17] The typical monthly bill is the product of the unit rate and the usage. The average monthly usage by a nonpermanent customer was calculated as 148 kwh, which is about a third of the average monthly usage by a permanent resident, 449 kwh. *See* CPUC Order, 2002 Cal. PUC LEXIS 326 at *42 (Attachment 1, Table C).

rates which are not just and reasonable, and does not say a little unlawfulness is permitted." *Texaco*, 417 U.S. at 399. *See also* Pet. App. at 64a.

The Commission on rehearing stated that the 38% overall increase in SCWC's retail rates among all its customer classes is not contrary to the public interest, because "[t]he bottom line for the public-interest test is not the percentage increase as compared to prior rates." JA 1578a. But FERC never defined that "bottom line"—and never defined "excessive burden" except by the circular statement that it must be "sufficient to modify the contract." JA 1579a. By itself, this failure justifies a remand. *See supra* Section I.B.

The undisputed fact is that SCWC's retail customers have paid far higher retail rates as a result of the costs of the Mirant contract. If the Mirant contract rate, measured against the statutory benchmark of competitive market prices, *see, e.g., Lockyer*, 383 F.3d at 1012-13; *La. Energy & Power Auth.*, 141 F.3d at 365, is so excessive as to be unjust and unreasonable under section 206, then—as defined in the FPA—the "burden" on consumers is "excessive," and the contract injures the public interest. How the CPUC allocated this excessive burden among SCWC's retail customers is irrelevant to FERC's obligation to set just and reasonable wholesale rates under the FPA.

B. The Commission's erroneous finding that SCWC profited from the resale of purchased power provided no basis for denial of the complaint.

Both the Commission and Mirant argue that SCWC made a profit from a resale of the power purchased from Mirant. FERC Br. at 44; Calpine Br. at 43. The

apparent argument is that the profit reduced any financial distress SCWC might have had from the Mirant contract. As noted above, however FERC now essentially concedes that such a financial-distress test was inapposite here. *See* FERC Br. at 41-42. In fact—as FERC conceded on rehearing, JA 1588a—the sale benefited SCWC's customers, not its shareholders, because SCWC credited the sale proceeds to the cost of purchased power borne in customer rates. ER 747-49. In any event, neither FERC's orders nor its brief recognizes that the sale revenue paled in comparison to the excessive charges SCWC paid to Mirant. Over the term of the latter contract, SCWC paid Mirant more than $69 million, and measured against FERC's benchmark price, SCWC paid $16 million too much. SCWC's sale (to Mirant) was only 15 MW for one month—the first month of the 69-month Mirant contract.[18] The gross proceeds from SCWC's sale were just $1.7 million, and by FERC's measure here, SCWC's "profit" was less than $650,000. And after the orders on review in this case were issued, on Mirant's protest, FERC ordered SCWC to refund about $429,000 of the sales revenue to Mirant, in a proceeding that remains pending at FERC following a judicial remand.[19] Thus, FERC's "profit" argument is a red herring.

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[18] SCWC was able to make this sale because the Mirant 15-MW purchase began on April 1, 2001, but SCWC's existing 12-MW purchase contract with Dynegy did not expire until April 30, 2001.

[19] *S. Cal. Water Co.*, 106 FERC ¶ 61,305, *reh'g denied*, 108 FERC ¶ 61,168, *modified*, 109 FERC ¶ 61,121 (2004), *rev'd*, 433 F.3d 840 (D.C. Cir. 2005).

C. The Commission failed to show from the "totality of the circumstances" that the contract rate was lawful.

In its brief, FERC points to its findings that the contracts were the result of "choices voluntarily made" by the purchasers, who "had better alternatives." FERC Br. at 43. *See also* Calpine Br. at 42 (SCWC had "ample alternatives" and "chose" to enter the contract). But FERC's conclusions in this regard were contrary to the undisputed evidence that the contract rate reflected prevailing market prices.

The Commission's finding that SCWC "voluntarily" chose to enter the contract, JA 1284a, did not demonstrate the lawfulness of the contract rate, because a contract can be voluntary even in a noncompetitive market. The Commission's finding that SCWC had "better alternatives," JA 1284a, was not supported by the record. The evidence introduced by SCWC *and Mirant* was that the contract rate reflected the then-prevailing market prices. The FERC orders cited no evidence of less-expensive contracts available at the time. All responses to SCWC's RFP reflected the dysfunctional California markets in March 2001. ER 758-60. There were no cheaper suppliers.

The only evidence of "better alternatives" that FERC cited in its orders was that SCWC "turned down the proposal by Dynegy Inc. to renew their existing contract at a rate substantially lower than the contract rate in question." JA 1285a. The record discloses that SCWC rejected Dynegy's October 2000 offer for sound reasons, because Dynegy would have required SCWC to forgo the last six months' purchases under their existing $35.50 contract in favor of an immediately higher-priced contract in November 2000. ER 756. Moreover, Dynegy's October 2000 offer

was not an "alternative" to Mirant's March 2001 offer. After FERC's December 2000 Order urged California utilities to sign long-term contracts and DWR entered the market as the largest purchaser, Dynegy made no more offers to SCWC and did not even respond to SCWC's RFP. By calling Dynegy's October offer a "better alternative," all that FERC appeared to be stating was that, in hindsight, SCWC would have been better off had it not been looking for a long-term power contract in March 2001. But FERC's own policy "strongly urge[d]" that very course after December 2000. And the Commission's hindsight criticism is not only invalid, it is irrelevant, because it does not support a conclusion that the Mirant contract rate was a lawful, competitive market price.

CONCLUSION

The Court should affirm the judgment of the court of appeals.

Respectfully submitted,

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